VZCZCXRO5635
PP RUEHCN RUEHGH RUEHVC
DE RUEHBJ #7238/01 2330915
ZNY CCCCC ZZH
P 210915Z AUG 06
FM AMEMBASSY BEIJING
TO RUEATRS/DEPT OF TREASURY WASHINGTON DC PRIORITY
RUEHC/SECSTATE WASHDC PRIORITY 4432
INFO RUEHOO/CHINA POSTS COLLECTIVE
RHEHNSC/NSC WASHDC
RUCPDOC/DEPT OF COMMERCE WASHDC

C O N F I D E N T I A L SECTION 01 OF 02 BEIJING 017238

SIPDIS

SIPDIS

STATE FOR EAP/CM, EB/IFD AND INR/B
TREASURY FOR OASIA/ISA - DOHNER/CUSHMAN
NSC FOR MCCORMICK, WILDER, TONG, HUNTER
STATE PASS USTR FOR STRATFORD, WINTER, ALTBACH
USDOC FOR 4420, DAS LEVINE
STATE PASS FEDERAL RESERVE BOARD FOR SCHINDLER/JOHNSON; SAN
FRANCISCO FRB FOR CURRAN/LUNG; NEW YORK FRB FOR
DAGES/CLARK/MOSELY

E.O. 12958: DECL: 08/21/2016
TAGS: CH ECON EFIN ETRD PGOV
SUBJECT: RMB FLEXIBILITY: VIEWS OF INCOMING AND OUTGOING
ACADEMIC MEMBERS OF PBOC'S MONETARY COMMITTEE

Classified By: ACTING ECONOMIC MINISTER COUNSELOR, CHRISTOPHER BEEDE; R
EASON 1.4(B) AND (D).

-- SUMMARY/COMMENT

¶1. (C) Summary: People's Bank of China (PBOC) Monetary Policy Committee (MPC) member Fan Gang told Finatt and Econoff on August 3 that the Chinese government could reduce the RMB's modest undervaluation while stemming speculative inflows by signaling to financial markets that the RMB would appreciate five percent per year over the next five years, but no more. Fan was subsequently appointed August 11 to replace Yu Yongding on the committee.

¶2. (C) Both noted in separate August 3 meetings that the senior leadership now understands better the link between exchange rate rigidity, excess liquidity, the growth of investment and credit, and the constraints the exchange rate policy imposes on monetary policy tightening. They saw this as welcome, given that they have become more concerned about the exchange rate's impact monetary conditions. According to Yu, President Hu Jintao, Premier Wen Jiabao, and MOFCOM Minister Bo Xilai have recently sought audiences with reform-oriented Chinese economists to discuss the exchange rate regime and its impact on investment and credit growth. The economists said that the Chinese government will likely allow for an accelerated pace of RMB appreciation, but did not expect any large or discrete changes.

¶3. (C) Comment: Dr. Yu had been the MPC's, and one of China's, most outspoken proponents of greater exchange rate flexibility. Fan was reined in earlier in his career for being too outspoken, and is likely to be more cautious arguing for a gradual, albeit accelerated rate of appreciation. Given future relative productivity increases, a five percent annual crawl may not be enough to affect materially China's external surplus, particularly if the USD weakens. To avoid speculative inflows, such a crawl could also lock China into excessively low interest rates. End Summary/Comment.

-- FAN: CONVINCE MARKETS THAT RMB WILL RISE SLOWLY, STEADILY

¶4. (C) Fan, who is also the Director of the National Economic Research Institute, told us that the Chinese government should signal to financial markets that the RMB

would continue to appreciate gradually over an extended period, and suggested a rate of five percent per year for the next five years. He argued that the current yearly two to three percent rate of appreciation is too low to reduce the RMB's undervaluation, which he termed modest, given relative productivity growth. A publicly announced annual appreciation of five percent, but no more, with clear signal that it would last for five years, would tackle the RMB's undervaluation while dampening speculative inflows. This would result from investors knowing that the government would allow for a sufficiently large appreciation (28 percent on a compounded basis) but, given interest rate differentials, would not make RMB assets significantly more remunerative to dollar assets to attract inflows. Fan termed five percent annually to be large enough to press Chinese companies to upgrade their operations yet gradual enough to avoid large scale dislocation.

-- SPECULATIVE INFLOWS CONTINUE, BUT THROUGH CURRENT ACCOUNT

¶5. (SBU) Fan said that since 2005, when the State Administration for Foreign Exchange (SAFE) began to enforce controls on capital inflows, speculative inflows have been entering by way of the under- and over-invoicing of current account transactions. He estimated that one-third of the current account surplus is actually disguised capital inflows. This helps explain the counter-intuitive and weakening link between investment and imports. (Note: During the first half of 2006, the rate of growth of fixed asset investment rose to a run-rate above 25 percent, while the rate of import growth was a downward trend. End Note.)

-- CHINESE LEADERS CONCERNED ABOUT RMB EXCHANGE RATE

¶6. (C) Fan said China's rapidly rising foreign reserves are contributing to increased concerns among Chinese government officials about an overheating economy. Chinese leaders now understand better the link between exchange rate rigidity and balance of payments surpluses, liquidity growth and excessive investment and credit.

-- "BIGGER STEPS" FOR RMB, BUT BASIC POLICY WILL NOT CHANGE

¶7. (C) Fan noted that Chinese leaders have been recently seeking economists' advice about the exchange rate regime. He said that MOFCOM Minister Bo Xilai recently invited reform-oriented economists to speak at a MOFCOM conference. He suggested, however, that strong political pressures still limit the scope for greater movement of the RMB. There remains concern that RMB appreciation would harm low value-added assembly operations, hurting migrant workers whose remittances support rural areas. The Chinese government will likely accept "bigger steps" in RMB appreciation, but the basic policy of a managed float will not change, in Fan's view.

-- THE POLICY MAKERS FOR THE EXCHANGE RATE

¶8. (C) Fan assessed that the key decision makers on the foreign exchange rate are Vice Premier Wu Yi and Vice Premier Zeng Peiyan. Zeng also plays a large role in day-to-day economic policymaking and favors a gradual approach to RMB appreciation. Fan described Premier Wen as one who seeks consensus on key economic issues such as the exchange rate before going ahead with a decision.

-- YU: LEADERS ENGAGE REFORM)ORIENTED ECONOMISTS ON LIQUIDITY

¶9. (C) Yu, Director of the Institute of World Economics and Politics, Chinese Academy of Social Sciences (CASS), separately told Finatt and Econoff that it was notable that President Hu Jintao, Premier Wen Jiabao, and MOFCOM Minister Bo Xilai had all recently sought audiences with

reform-oriented Chinese economists to discuss the exchange rate regime and its impact on overheating. Yu noted this indicates greater awareness to the risks of exchange rate rigidity. If senior officials continued to see signs of the economy overheating, then the government would allow for a more flexible exchange rate, though any changes would be gradual, Yu suggested.

¶10. (SBU) Yu also said that higher interest rates have limited effectiveness in constraining investment growth because large enterprises are increasingly financing investment through retained earnings.

SEDNEY